



Something for Nothing

"Cash Flow" as a
Contract Incentive

John Pritchard ■ John Krieger

Pritchard and **Krieger** are professors at the Defense Acquisition University's Defense Systems Management College at Fort Belvoir, Virginia.



During our combined 70 years in acquisitions, we often have wondered why the government believes it needs to devote additional resources for incentives to achieve a benefit. The government actually has complete control over one of the strongest contract incentives possible—cash flow. Most important, in our fiscally constrained, sequestration-challenged environment, this incentive wouldn't require additional resources: It uses funds already budgeted or obligated. Unfortunately, we haven't really tried to exploit it as we should. So let's get to it.

A contractor's need for cash flow and the desire for it to flow as quickly as possible provide a unique opportunity to employ positive and negative cash-flow incentives. Cash flow is a major driver in a contractor's decision to bid or make no bid on a government acquisition. We believe linking successful contractor performance to progress payment rates and liquidation rates would provide an effective incentive. Moreover, this cash-flow incentive links directly to implementing the Better Buying Power Initiatives issued by the Under Secretary of Defense for Acquisition, Technology, and Logistics (USD[AT&L]).

In his memorandum titled *Better Buying Power [BBP] 2.0: Continuing the Pursuit for Greater Efficiency and Productively in Defense Spending*, USD(AT&L) Frank Kendall emphasized affordability, while increasing

productivity and value to the taxpayers and warfighters. One of Kendall's seven focus areas was "Incentivize Productivity and Innovation in Industry and Government."

BBP 2.0 was a significant change from former USD(AT&L) and current Defense Secretary Ashton Carter's original BBP, "Incentivize Productivity and Innovation in Industry." That focus area had not included government.


The interim release of BBP 3.0 addressed the topics of "Incentivize Productivity in Industry and Government" and "Incentivize Innovation in Industry and Government." Kendall emphasized the continuity with both BBP 1.0 and BBP 2.0:

BBP 3.0 continues the focus on continuous improvement with a new emphasis on initiatives that encourage innovation and pro-

Northrop Grumman Corp.'s report stated:

Changes to business practices for U.S. Government contractors could have a significant adverse effect on current programs, potential new awards and the processes by which procurements are awarded and managed.

Successful contractors are experts in managing and controlling the cash they need to pay for investments, bills, employees, subcontractors, taxes and all the other cash outflows. If existing funds are insufficient to cover expenditures, the contractor will need to borrow funds and the interest on that loan will be an "unallowable" expense (Federal Acquisition Regulation [FAR] 31.205-20). Therefore, even before proposing on contract efforts, industry considers the importance of cash flow in its decisions to bid or make no bid.



Our proposed incentive concept is to directly tie the progress payment and liquidation rates of a contract to a contractor's performance.

mote technical excellence with the overarching goal of ensuring that the United States' military has the dominant capabilities to meet future national security requirements.

Cash flow is vitally important to a contractor's business health, and its importance cannot be overstated. Without cash flow, business grinds to a halt and does so quickly. Employees, subcontractors, vendors and, especially, lenders show little patience in waiting for the funds due to them.

We've heard it said that "revenue is vanity, but cash is king." If you don't believe that, consider that in the 2013 annual reports for the top three defense contractors the terms free cash flow(s) or cash flow(s) appeared a combined 225 times. The reports indicate that industry is concerned about ensuring that flow continues unabated. Lockheed Martin Corp.'s report stated:

Other policies could negatively impact our working capital and cash flow. For example, the government has expressed a preference for requiring progress payments rather than performance based payments on new fixed-price contracts, which if implemented, delays our ability to recover a significant amount of costs incurred on a contract and thus affects the timing of our cash flows.

To better understand this concept, let's review some of the basics of fixed-price contract financing methods—specifically, progress payments. Under a fixed-price contract arrangement, a contractor only receives contract payments upon delivery of supplies or services, unless other contract financing arrangements are employed (see FAR Part 32 Contract Financing). Companies generally cannot wait for extended periods (sometimes 1, 2, or even 3 years) to receive payments for work accomplished but not yet delivered. There can be significant cash requirements for some supply contracts, particularly those for major systems. Consider, for example, expendable vehicles used to launch satellites, which historically have had a development to production time of 7 to 10 years, and a production to launch time greater than 2 years. That is a very long time to ask a contractor to wait for payment.

To address this problem, the government often uses a financing arrangement on fixed-price contracts called progress payments. This arrangement allows for contract payments at regular intervals for work in process that has not yet been delivered.

Let's look at progress payments as discussed in the FAR:

- Progress payments are a contract financing method addressed in FAR subpart 32.5—Progress Payments Based

on Costs. Progress payments may be customary or unusual. Customary progress payments are those made under the general guidance in subpart 32.5, using the customary progress payment rate, the cost base and frequency of payment established in the Progress Payments clause, and either the ordinary liquidation method or the alternate method. According to FAR 32.501, unusual progress payments are anything else.

- Customary progress payments have a payment rate and a liquidation rate for invoice payments and deliveries, respectively. When a contractor submits its invoice for payments, the full amount is not paid; a portion is reserved for final payment.
- For a large business, the customary progress payment rate and the liquidation rate are 80 percent, and for a small business the rates are 85 percent. (Note: In accordance with DFARS [Defense Federal Acquisition Regulation Supplement] 232.501-1(a), within Department of Defense [DoD] the rates are 80 percent for large business concerns, 90 percent for small business concerns and 95 percent for small disadvantaged business concerns.)
- Progress payments are liquidated by deducting from any payment under the contract for delivery and acceptance the unliquidated progress payments, or 80 percent of the amount invoiced for large businesses or 85 percent for small businesses—whichever is less.
- Unusual progress payments are any other than customary progress payments, and may be used only in exceptional cases, and when authorized in accordance with subsection FAR 32.501-2. Typically, unusual progress payments would be used if the contract necessitates predelivery expenditures that are large in relation to contract price and in relation to the contractor’s working capital and credit. Other than the difference in rate, these unusual progress payments operate the same as customary progress payments. Special permission is required to use unusual progress payments.

To understand the progress payment and liquidation concepts, consider the simplest of contracts, a contract for the delivery of a single supply item—the production of one launch vehicle. Presume that (1) a contract exists for one noncommercial medium expendable launch vehicle system, (2) the price of the system is \$100 million, and (3) progress payments made to the contractor before the customer accepted the system were \$70 million (80 percent of costs incurred). Then the normal progress payment liquidation procedure would be as follows:

\$ 100,000,000

- \$ 70,000,000

\$ 30,000,000

Contract Price

Minus Progress Payments

Equals Amount Paid Upon Delivery and Acceptance

(Note: For a more detailed discussion of the progress payment and liquidation concepts, see the Defense Acquisition University White Paper, “Liquidating Progress Payments Based on Costs Using the Alternate Liquidation Rate Method” [Oct. 5, 2010].)

The progress payment and liquidation rates directly affect a contractor’s cash flow, based on the amounts paid and the amounts withheld. If the large business customary progress payment rate is used under a fixed-price contract, the contractor can bill and be paid only for 80 percent of the costs incurred until it makes delivery. This means the company has to fund 20 percent of the costs incurred until it makes delivery. Even when delivery is made, the progress payments will not be liquidated at the full amount but at the reduced liquidation rate until final contract closeout.

Our proposed incentive concept is to directly tie the progress payment and liquidation rates of a contract to a contractor’s performance. The difference between the limits on customary rates and what could conceivably be used as unusual rates provide the government an additional opportunity for incentivizing contractors. Under such an arrangement, the program manager and contracting officer, with proper approvals in accordance with agency procedures, could establish objective (measurable) levels of contractor performance (e.g., cost or performance, including schedule) above minimum contract requirements, for which the government would be willing to provide unusual progress payments.

Using objective performance criteria, the government could directly link liquidation rates to performance. Progress payment and liquidation rates could be changed over stated periods or intervals (e.g., measuring performance annually and then making any adjustments to the rates). However, if a company doesn’t excel, it would not be entitled to use this approach to increase cash flow. An example would be an incentive on payload margin for our medium launch vehicle, where the minimum requirement is 100 pounds of margin and the contract was awarded to a large business:

Margin (lbs.)	Progress Payment/Liquidation Rate
100	80 Percent
150	85 Percent
200	90 Percent

Once this approach is implemented, if the contractor provides that higher level of performance, its progress payments and liquidation rates would increase, thereby improving its cash flow. However, once the higher rate is earned and awarded, if the contractor later falters, the payment and liquidation rates would return to the lower customary progress payment and liquidation rates. This last part provides an additional incentive for the contractor to continue a high standard of performance. No contractor would want its cash flow reduced after achieving a higher level.

Variations on the approach just described are possible. There is no reason that the changes to the progress payment rate and the liquidation must be symmetrical. For instance, an incentive could be structured that increased the progress payment rate but not the liquidation rate. Alternatively, an

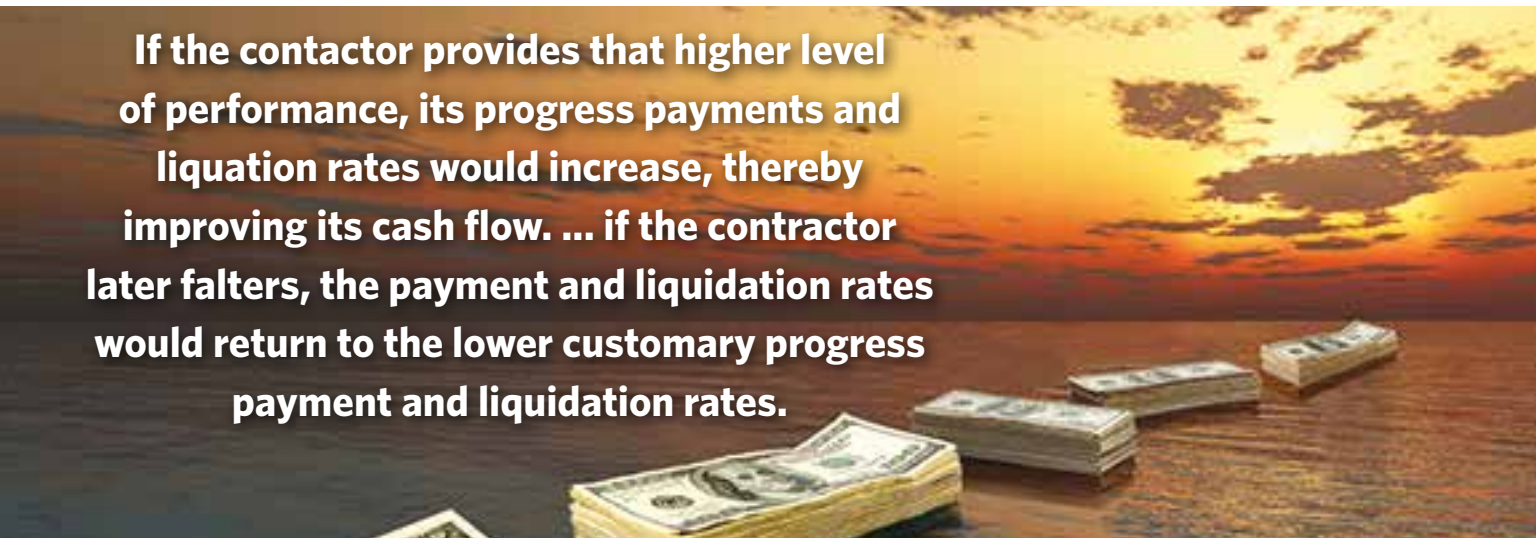
incentive could be structured that adjusted the progress payment rate to one level but the liquidation rate to a different level. But, whatever the approach, the government must ensure that its rights are protected.

There are clear advantages to this type of incentive approach—advantages to both the government and contractors:

- For existing contracts, this incentive approach would use funds already budgeted or obligated. It doesn't require any additional or special funding for the contract. The "cost" of

under way. This incentive approach could easily be applied to contractors that are helping DoD achieve its BBP objectives. For instance, it could be used implementing the superior supplier's initiative.

Existing laws pertaining to progress payments (10 U.S. Code [U.S.C.] § 2307(2) and 41 U.S.C. § 255)) do not prohibit this type of approach. However, some policy changes would need to be addressed to implement this incentive. The DoD would need to make a few policy changes to the DFARS and issue a deviation from some FAR requirements. The approach de-



If the contractor provides that higher level of performance, its progress payments and liquidation rates would increase, thereby improving its cash flow. ... if the contractor later falters, the payment and liquidation rates would return to the lower customary progress payment and liquidation rates.

the incentive is based solely on changing progress payment and liquidation rates for funds already obligated.


- The incentive is used to leverage areas the government wants to incentivize (e.g., cost or performance, including schedule).
- The increases and decreases in the progress payment and liquidation rate would be tied to objective measures, and subjectivity would be eliminated, at minimal administrative cost.
- The approach is particularly suited as a reward in the superior supplier incentive program. The DoD could offer this incentive only to those companies that qualify as superior suppliers. Once in the superior category, these contractors would be expected to show superior performance to earn or maintain the higher payment rate.
- While imposing no added cost to the DoD, except expedited outlays, the incentive approach provides an effective way to secure a contractor's attention.

Embedded in that last bulleted item may be the only downside, the acceleration of outlays. Although this may not be a concern in the DoD, it certainly will be an issue with the Treasury Department. Treasury just does not like to see money go out; it only likes to see money come in.

The DoD is implementing the BBP 1.0 and BBP 2.0 initiatives and implementation of additional initiatives from BBP 3.0 is

scribed would require a deviation from, or supplementation to, FAR 32.501-2(a). The deviation or supplementation would add an additional reason to the one already at FAR 32.501-2(a) (1) for using unusual progress payments as a contract incentive. DFARS 216.4—Incentive Contracts would also have to be supplemented to discuss the approach.

Implementation of this incentive approach would begin with forming a "Reinvention Lab" (i.e., assigning one buying activity to test this incentive). The test case could be designed to measure the real world impacts of this approach, both positive and negative. The results of this test would then form the basis for a final decision on full implementation across the DoD.

The government appears to be missing an excellent opportunity to incentivize industry without applying additional resources. We suggest that the USD(AT&L) or the Director of Defense Procurement and Acquisition Policy explore this opportunity. This incentive would provide significant value in implementing the BBP Initiatives, especially in a period of declining government resources. As negligible resources are required to implement the incentive, this is the closest the government ever will come to getting something for nothing. 

The authors may be contacted at john.pritchard@dau.mil and john.krieger@dau.mil.